## B. RENTS FROM REAL PROPERTY - RENDERING OF SERVICES

1. Introduction

IRC 511 imposes a tax on the unrelated business taxable income of organizations described in IRC 501(c). IRC 512(b)(3)(A) excludes from the definition of unrelated business taxable income all "rents from real property."

2. Regulations

Reg. 1.512(b)-1(c)(5), which concerns permissible services that can be rendered in conjunction with the rental of facilities, states as follows:

> For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

3. Committee Reports

The relevant committee reports explaining the reasons for enacting what is now IRC 512(b) are contained in The Report of the Senate Finance Committee on the Revenue Act of 1950 (Senate Report No. 2375, 1950-2 C.B. 483). That report states, in relevant part (at pp 506 and 560), as follows:

> Dividends, interest, royalties, most rents (emphasis added), capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts . . . The term "rents from real property" does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself. Similarly, income derived from the operation of a parking lot is not considered "rents from real property."

The language contained in the Senate Finance Committee report provides little guidance in actually defining the term "rents from real property" and said nothing specifically about the "rendering of services." This was left to the drafter of Regulation 1.512(b)-1(c)(5).

4. Problems Raised in Recent Rulings Requests

Three problems have come up in recent rulings requests submitted to the Service:

A. Substantiality Test

The first problem concerns to what extent there is a substantiality test in applying the regulations. For example, if services provided primarily for the convenience of the occupant are insubstantial would the income then qualify as "rents from real property" excluded from the computation of unrelated business taxable income under IRC 512(b)(3)(A)? The regulations do not use a substantiality test but cite examples of activities where services are generally rendered to occupants, such as hotels, boarding houses, apartment houses furnishing hotel services, tourist homes, motor courts, and motels.

A number of revenue rulings have imputed a substantiality test in applying Reg. 1.512(b)-1(c)(5). For example, Rev. Rul. 69-69, 1969-1 C.B. 159, held that the rendering of maid, switch board and dining hall services constitute the substantial rendering of services to tenants renting studio apartments; Rev. Rul. 80-297, 1980-2 C.B. 196, held that a school operating a tennis club through its own employees, who performed substantial services for the participants in the club, could not exclude the income received as rent from real property; Rev. Rul. 80-298, 1980-2 C.B. 197, held

that a university leasing its stadium to a professional football team and furnishing grounds and playing field maintenance, dressing room linens, and stadium dressing rooms was furnishing substantial services for the convenience of the lessee. However, it should be noted that none of the above-cited rulings attempt to quantify the amount of impermissible services. The issue to be resolved is: What is the extent of impermissible services that may be rendered to occupants without tainting the entire amount of rental income, thus excluding it from the definition of "rents from real property"?

B. Operation of Parking Lots

The second problem concerns whether an exempt organization that operates a commercial parking lot on a self-park and lock basis receives rents from real property excludible under IRC 512(b)(3)(A). Reg. 1.512(b)(c)(5) starts out by stating that "payments for the use or occupancy of rooms where services are also rendered to the occupant" are not rents from real property. The section then lists certain examples that are considered to be excluded from the term. However, the examples include two distinct types of "occupancy". First is the use or occupancy of rooms or other quarters in hotels, apartment houses, etc., where the hotel-type services are provided. Second is the "use or occupancy of space in parking lots, warehouses, or storage garages." Arguably, parking lots, warehouses, and storage garages are, per se, excluded from the definition of "rents from real property." A common thread linking the three specified activities is that they would generally be considered as bailment activities where the bailor delivers personal property to be held by the bailee for a fee. In that case, the only thing provided is a service for the benefit of the occupant.

It should be pointed out that there have been inconsistencies in private letter rulings (PLR's) issued by the Service concerning the taxability of parking lot income. In PLR 7852007 (September 13, 1978) parking lot income was held subject to the unrelated business income tax imposed by IRC 511. The rationale was that "section 1.512(b)-1(c)(5) of the regulations specifically provides that income from the rental of parking spaces does not constitute rent for the purpose of this section." However, PLR 8445005 (July 11, 1984) reached the opposite conclusion on a similar set of facts. The relevant facts and rationale used were as follows:

> X (the exempt organization) provides no services to the parking customer. Instead, X merely provides the customer with the restricted use of real property for a fee. Although the daily parking customer makes arrangements for a very limited period of time, as in Rev. Rul. 69-178, this does not preclude the treatment of X's receipts as rent. The

reference to parking in section 1.512(b)-1(c)(5) of the regulations shows only that parking receipts do not constitute rent if services are also rendered. So long as the payments are for the use of real property, and no services primarily for the convenience of the customer are provided, payments by the customer to the operator of the parking facility constitute rent, and are therefore excluded under section 512(b)(3) of the Code.

C. Attribution of Activities to Parent

The third problem concerns whether rents received by an exempt organization from the ownership and operation of a commercial shopping center may be excluded under IRC 512(b)(3)(A) where, in addition to custodial, utility, and trash collection services, the tenants are provided marketing, public relation, security, and other services generally impermissible under the regulation. It is conceded by the taxpayer that the rendering of such services would exclude the income from the definition of "rents from real property" if the facility were operated directly. However, the exempt organization has entered into a management agreement with a wholly-owned, for-profit subsidiary to act as an agent, for a fixed fee plus a percentage of gross rents, to conduct day-to-day operations of the shopping center. The question currently being considered is whether the activities of the agent should be attributed to the exempt parent, thus making the rental income taxable under IRC 511. A secondary question being considered is whether the result would be different if the management agreement were entered into with a totally unrelated organization.